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ABSTRACT

The salary reduction plan for financing child care is of little benefit to taxpayers earning below 16,000 dollars because these working parents would receive equal or better value by using the child care tax credit. For income levels between 16,000 and 20,000 dollars, the salary reduction plan may have some marginal utility to working parents (that marginal utility increasing as the cost of child care increases). At 2,400 dollars of child care cost per year, the salary reduction option provides little benefit; however, at 5,000 dollars of cost per year, the salary reduction option could double the savings available to a family earning 20,000 dollars. Nonetheless, consideration must be given to how likely it is that working parents earning 20,000 dollars will spend 5,000 dollars on child care. For income above this figure, salary reduction offers substantial and ever-increasing tax benefits. Without federal government programs addressing the needs of low-income working parents, salary reduction becomes nothing more than a massive income redistribution plan on behalf of those most able to afford child care for their children. Further, salary reduction permits companies to meet parents' needs through government subsidy; with salary reduction no incentive will exist for business to establish alternate dependent care assistance programs. If salary reduction plans are approved by the Internal Revenue Service they should be capped at 3,000 dollars per individual. Savings thereby accruing to the federal government should be used to fund child care services for low-income working parents. (Author/RH)

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The Inequities of Salary Reduction
as National Child Care Policy;
Where Do We Go From Here

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By: **Ronald Soloway**
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Introduction

Today working parents can receive child care assistance in three ways: direct subsidy through Title XX and Title IV-A, child care income tax credits and employer contribution. Each of these assistance programs offers varying benefits to working parents depending on income, number of children, geographical location and place of employment. This paper considers whether salary reduction plans as part of employer-supported Dependent Care Assistance Plans will offer any additional child care assistance to those working parents most in need.

The Internal Revenue Service is currently considering whether to approve salary reduction plans under Section 125 of the United States Tax Code which authorizes their use in conjunction with dependent care assistance programs. Salary reduction is an option for an employer interested in subsidizing their employees child care costs. This occurs through mutual agreement between the employee and employer to lower the taxable income of the employee, the amount of which would be given to the employee in the form of pre-tax dollars usable for child care. For instance, an employee earning \$20,000 could lower his/her salary by \$3,000 paying taxes on a \$17,000 salary and using the valuable \$3,000 for child care expenses. Of clear value to some employees, salary reduction is also valuable to the employer since they can "assist" employees with their child costs without contributing anything financially. In fact, the employer saves money on reduced social security and unemployment insurance payments and ultimately in the productivity gains made by employees with more satisfactory and stable child care arrangements.

Along with flexible benefits, Dependent Care Assistance Plans, vouchers and flexible spending accounts, salary reduction is being presented as a unique opportunity to involve

employers in child care and create affordable child care for working parents. However, there may be some potentially negative implications to the widespread use of salary reduction as the mechanism to achieve these goals, particularly for low wage earning employees. This paper begins to explore some of the potential inequities in salary reduction when offered by employers and the subsequent effect of those inequities given current government policy.

It is the position of the Center for Public Advocacy Reserach, Inc. that day care should be universally available and affordable to all families desiring it for their children. In the absence of a national child care policy providing such child care, we believe that government should subsidize the child care services for those parents least able to afford it themselves. Further, we believe that those employers able to act in their own economic interest will be more likely to provide child care benefits to their most valued and highly paid workers, leaving greater numbers of lower paid, unskilled working parents without corporate support for their child care needs.

Summary and Highlights

Our analysis of the salary reduction option under Dependent Care Assistance Programs reveals that:

- o Salary reduction of \$2400 will provide limited benefits to working parent(s) with incomes below \$20,000 because these working parents do better taking advantage of the child care tax credit. Salary reduction at the \$5,000 level will be more beneficial to taxpayers with gross incomes above \$15,000 but many of those taxpayers will not spend 1/3 of their income on child care.

- o The federal government will be providing massive subsidies to those working parents most able to afford paying their own child care costs. This will be occurring in light of recent cutbacks in federal child care funds available under Title XX and Title IV-A.
- o Salary reduction is attractive to employers because they can support child care without cost to the company -- in fact, they might save money. It effectively lifts the economic burden from employers for meeting the child care needs of its employees -- shifting it back to government and individual workers -- despite the benefits accruing to business from a workforce more productive because of stable child care arrangement.
- o Dependent Care Programs due to their "non-discriminatory" coverage would be more likely to benefit lower paid workers. On the other hand, because of the availability of the child care tax credit, salary reduction tends to benefit higher income workers.
- o The benefits under salary reduction should be capped so funds will be available to expand federal support to lower income working parents through increased contribution to Title XX and IV-A and by increasing the value of the child care tax credit.

Analysis

To begin our analysis of the utility of Salary Reduction plans to different family income groups we assumed several criteria:

1. An analysis of how salary reduction and the child care tax credit impact on a family of three with one wage earner accurately reflects the impact on other family groupings.

2. The use of \$2400 and \$5000 levels of cost for child care can accurately reflect the different economic impact between use of the child care tax credit and salary reduction.
3. That family of three with one wage earner must have an after tax income of \$10,400 to pay for household necessities before funds become available for child care.*

The first step in the analysis was to determine at what income level this family of three with one wage earner could afford to purchase child care services. As detailed in Table 1, it was determined that funds become available for child care at approximately \$12,000 of income. Below this level, this family cannot avail itself of the benefits of either salary reduction or the child care tax credit and must, of necessity, rely on publicly subsidized child care.**

*The following costs for household necessities are below the "lower level" standard of living for the New York City-Northern New Jersey metropolitan area but may be equivalent to this standard in many parts of the United States.

Food	=	\$3950.00
Housing	=	2100.00
Home Furnishing & Upkeep	=	532.00
Transportation	=	814.00
Clothing	=	700.00
Personal Care	=	304.00
Medical Care	=	1000.00
Other	=	1000.00
		<u>\$10,400.00</u>

**In New York State this family would be charged about \$500 for publicly subsidized child care -- funds (\$350 due to a \$150 tax credit) that would have to be paid by forgoing a portion of the necessities of life.

Interestingly, this family is unable to benefit from the highest percentage of the child care tax credit (30%) because the family has no disposable income to spend on child care if total income is less than \$10,000, and for slightly higher wage earners, because of lack of refundability of the child care tax credit. In fact, this family will not reach maximum eligibility for the child care tax credit (\$2400) until income reaches a little above \$15,000.

TABLE ONE

FAMILY INCOME AVAILABLE FOR CHILD CARE PAYMENTS BY INCOME
FOR A FAMILY OF THREE WITH ONE WORKING PARENT

<u>Gross Annual Family Income</u>	<u>Taxes-Income and Social Security*</u>	<u>Net Annual Family Income</u>	<u>Required Family Consumption Budget</u>	<u>Available Funds for Child Care</u>
\$10,000.00	\$1,249.00	\$8,751.00	\$10,400.00	(\$ 1,249.00)
12,000.00	1,692.00	10,308.00	10,400.00	(92.00)
15,000.00	2,435.00	12,565.00	10,400.00	2,165.00
16,000.00	2,692.00	13,308.00	10,400.00	2,908.00
17,000.00	2,949.00	14,051.00	10,400.00	3,651.00
18,000.00	3,206.00	14,794.00	10,400.00	4,394.00
19,000.00	3,483.00	15,517.00	10,400.00	5,117.00
20,000.00	3,760.00	16,240.00	10,400.00	5,820.00
23,500.00	4,781.00	18,718.50	10,400.00	8,318.50
30,000.00	7,022.00	22,978.00	10,400.00	12,578.00

*In calculating income tax three dependents @ \$1,000 each are subtracted from gross income. 1983 tax tables are used.

If we assume child care costs of \$2400 for the year (Table 2), the net gain from using the child care tax credit is more beneficial to families with gross annual incomes of \$19,000.00 but is less desirable for the family at the \$20,000.00 income level. At the \$20,000.00 income level the advantage to the family of using the salary reduction option rather than the tax credit is \$32.80; at \$23,500.00, the advantage of using salary reduction is \$140.80; and at \$30,000.00 the advantage of salary reduction is \$352.80. At \$87,200.00 the benefit of salary reduction maximizes at \$1200.00 (\$720.00 above the available

child care tax credit) because these taxpayers can take full advantage of the full \$2400 pre tax deduction within the 50% maximum tax bracket.

TABLE TWO

RELATIVE ADVANTAGE OF CHILD CARE TAX CREDIT VS.
SALARY REDUCTION BY GROSS FAMILY INCOME FOR
A FAMILY OF THREE WITH ONE WORKING PARENT
PAYING \$2400 PER YEAR FOR CHILD CARE

<u>Gross Annual</u> <u>Family Income</u>	<u>Funds</u> <u>Available</u> <u>for</u> <u>Child Care</u>	<u>Taxes on</u> <u>Income with</u> <u>Child Care</u> <u>Tax Credit</u>	<u>Taxes</u> <u>on Income</u> <u>with Salary</u> <u>Reductions</u>	<u>Net Gain</u> <u>Using Child</u> <u>Tax Credits</u>	<u>Net Gain</u> <u>Using</u> <u>Salary</u> <u>Reduction</u>
\$10,000.00	(\$ 1,249.00)	N.A.	N.A.	N.A.	N.A.
12,000.00	92.00)	N.A.	N.A.	N.A.	N.A.
15,000.00	2,165.00	1,807.15	1,898.24	627.85	536.76
16,000.00	2,908.00	2,020.00	2,087.20	672.00	604.80
17,000.00	3,651.00	2,277.00	2,334.20	672.00	614.80
18,000.00	4,394.00	2,558.00	2,589.20	648.00	616.80
19,000.00	5,117.00	2,835.00	2,846.20	648.00	636.80
20,000.00	5,820.00	3,136.00	3,103.20	624.00	656.80
23,500.00	8,318.50	4,205.50	4,064.70	576.00	716.80
30,000.00	12,578.00	6,518.00	6,156.20	504.00	856.80

If we assume child care costs of \$5000.00 per year, the relative advantage of salary reduction over the child care tax credit occurs at approximately \$15,500.00 of income. At \$16,000.00 of income the advantage of salary reduction is \$58.28, at \$18,000.00 the advantage is \$376.00; at \$20,000 the advantage is \$701.00; at \$23,500 the advantage is \$861.00; and at \$30,000.00 the advantage is \$1221.00. Thus, the family earning \$30,000 has a tax advantage via salary reduction of \$1725.00 (vs. a \$504.00 savings with the child care tax credit) benefiting in the amount of \$1221.00 over current tax policy.

On the other hand, the family earning \$16,000 has a tax advantage via salary reduction of \$703.28 (vs. a \$672.00 child care tax credit) benefiting in the amount of \$58.28 over current tax policy. A further analysis of Table Three indicates the

relative advantages of the salary reduction option to wealthier taxpayers while those taxpayers considered low income working class receive relatively little tax advantage. Benefits under salary reduction maximize at \$2500 (\$2020.00 above the available child care tax credit) for families of this type earning \$89,800.00 where they can take advantage of the full \$5000.00 pre tax deduction within the 50% tax bracket.

TABLE THREE

RELATIVE ADVANTAGE OF CHILD CARE TAX CREDIT VS.
SALARY REDUCTION BY GROSS FAMILY INCOME FOR A
FAMILY OF THREE WITH ONE WORKING PARENT PAYING
\$5000 PER YEAR FOR CHILD CARE

<u>Gross Annual</u> <u>Family Income</u>	<u>Funds</u> <u>Available</u> <u>for</u> <u>Child Care</u>	<u>Taxes on</u> <u>Income with</u> <u>Child Care</u> <u>Tax Credit</u>	<u>Taxes</u> <u>on Income</u> <u>with Salary</u> <u>Reductions</u>	<u>Net Gain</u> <u>Using Child</u> <u>Tax Credits</u>	<u>Net Gain</u> <u>Using</u> <u>Salary</u> <u>Reduction</u>
\$10,000.00	(\$ 1,249.00)	N.A.	N.A.	N.A.	N.A.
12,000.00	(92.00)	N.A.	N.A.	N.A.	N.A.
15,000.00	2,165.00	1,807.15	1,898.24	627.85	536.76
16,000.00	2,908.00	2,020.00	1,961.72	672.00	730.28
17,000.00	3,651.00	2,277.00	2,025.20	672.00	923.80
18,000.00	4,394.00	2,558.00	2,182.08	648.00	1,024.00
19,000.00	5,117.00	2,835.00	2,186.00	648.00	1,297.00
20,000.00	5,820.00	3,136.00	2,435.00	624.00	1,325.00
23,500.00	8,318.50	4,205.50	3,344.50	576.00	1,437.00
30,000.00	12,578.00	6,518.80	5,297.00	504.00	1,725.00

Summary and Conclusion

This paper demonstrates that salary reduction is of little benefit to taxpayers below \$16,000 because these working parents would receive equal or better value by using the child care tax credit. Between income levels of \$16,000 and \$20,000, the salary reduction may have some marginal utility to working parents with that utility increasing as the cost of child care increases. At \$2400 of child care cost per year, the salary reduction option poses little benefit; but at \$5000 of child care cost per year, the salary reduction option could double

the savings available to a family earning \$20,000. One must consider, however, how likely working parents earning \$20,000 are to be spending \$5000 on child care. Above \$20,000 of income, salary reduction offers substantial and ever increasing tax benefits to working parents.

Within the context of this paper, it is impossible to calculate the total dollar value the government will spend to subsidize child care should salary reduction be approved by the Internal Revenue Service. Needless to say, the amount will be substantial. Having made such a large investment in child care benefiting middle and upper income families, government must be asked what the concomitant commitment is to the working poor and blue collar family. Will Title XX and Title IV-A child care funds be increased? Will the child care tax credit be increased for lower-income working families? Will the child care tax credit be made refundable? Without federal government commitment to address the child care needs of the neediest working parents, salary reduction becomes nothing more than a massive income redistribution plan on behalf of those most able to afford child care for their children.

And what does a salary reduction option do for business? At a time when business is being pressured by a changing workforce, labor shortage and employee demands for child care, salary reduction permits companies to meet their needs through government subsidy. Under current regulations, business could set up a dependent care assistance plan to meet the child care needs of its working parents -- supported through corporate financing much like other fringe benefits. With salary reduction, there will be no incentive for business to establish DCAP's without salary reduction. Hence, no corporate contribution to the child care needs of its working parents.

The recent design of various subsidy programs by business,

whether through Dependent Care Assistance or vouchers, generally tends to take into account employee earnings. For a number of companies, like Polaroid and the Ford Foundation, greater benefits are offered to the lower wage earning employees in recognition of their greater needs. Salary reduction creates incentive patterns, described earlier, which result in greater benefit to the wealthier working parent(s).

Salary reduction must be seen for what it is -- income redistribution to the wealthier and welfare for the corporate sector. And what do the working poor get out of salary reduction? Very little. In fact, they might actually suffer more if the reduced federal revenues accruing from salary reduction plans create the need to further reduce federal spending and such cuts are made to Title IV-A, Title XX or the Child Care Feeding Program.

Those attempting to influence corporate activity in child care must examine the potential dangers of lobbying against salary reduction for it surely will be of some value to struggling middle class earners. The major inequity is that government under salary reduction subsidizes the wealthier wage earner and businesses which should be contributing to the child care need of its working parents.

A way must be found to increase government and business contributions to the child care needs of low income working parents. Perhaps the discussion should focus on what tradeoffs we want from the federal government and corporate sector for our support of salary reduction. What can we get? What strategy should we use?

In the meantime, we suggest that if salary reduction plans are approved by the Internal Revenue Service they should be

capped at \$3000 per individual. This limitation would help assure the non-discriminatory nature of Dependent Care Assistance Plans and reduce federal outlays -- savings which we as child care advocates can argue should be used to fund child care services for low-income working parents through Title XX and IV-A or by increasing the value to this population of the child care tax credit.